

# ***YIN WELCOME: FOREIGN AFFILIATE INCOME RECHARACTERIZATION RULES***

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# **IFA CANADA INTERNATIONAL TAX CONFERENCE**

*IN-PERSON EVENT*



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# OUTLINE

1. FAPI & Income from property
2. When is income from property recharacterized as income from an active business?
3. When is services income recharacterized as FAPI?

# 1. FAPI & INCOME FROM PROPERTY

# Definition of “FAPI” in 95(1) – Element A

- **Income from property**

- Includes the expected types of income from property (i.e., interest, dividends), income from an “investment business” and income from an adventure or concern in nature of trade.
- It is possible for certain property income to be recharacterized under 95(2)(a) to income from an active business (“**ABI**”).

- **Income deemed to be from a business other than an active business (“deemed inactive business income”)**

- Includes income related to the provision of certain services recharacterized under 95(2)(b).

# “Investment Business”

- Income from an investment business → income from property (and is FAPI).
  - Notwithstanding an "investment business" is a business, it is not 'active' enough.
- **“Investment business”** – principal purpose of business is to earn income from property, income from the insurance and reinsurance of risks, factoring of trade A/R or profits from the disposition of investment property.
- **Exception:**
  - Business (other than business conducted principally with NAL persons) relates to development of real property for sale, lending of money or licensing of property, insurance or reinsurance of risks; and
  - FA employs > 5 full time employees in active conduct of the business; or equivalent of > 5 full time employees considering services performed outside of Canada by related persons.

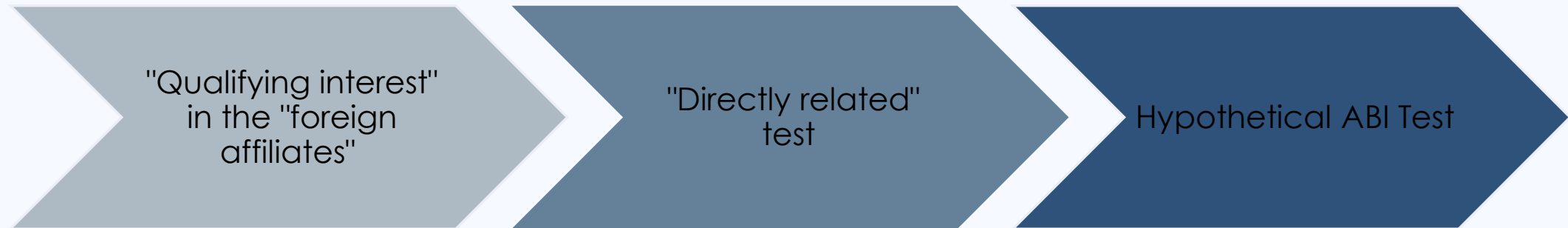
## Recharacterization Rules

- 95(2)(a) – recharacterizes certain property income into ABI
- 95(2)(b) – recharacterizes certain ABI to deemed inactive business income (or FAPI)

**Note:** partnerships not covered in this presentation

2. WHEN IS INCOME FROM  
PROPERTY  
RECHARACTERIZED AS  
INCOME FROM AN ACTIVE  
BUSINESS?

# Mothership – 95(2)(a)(i)

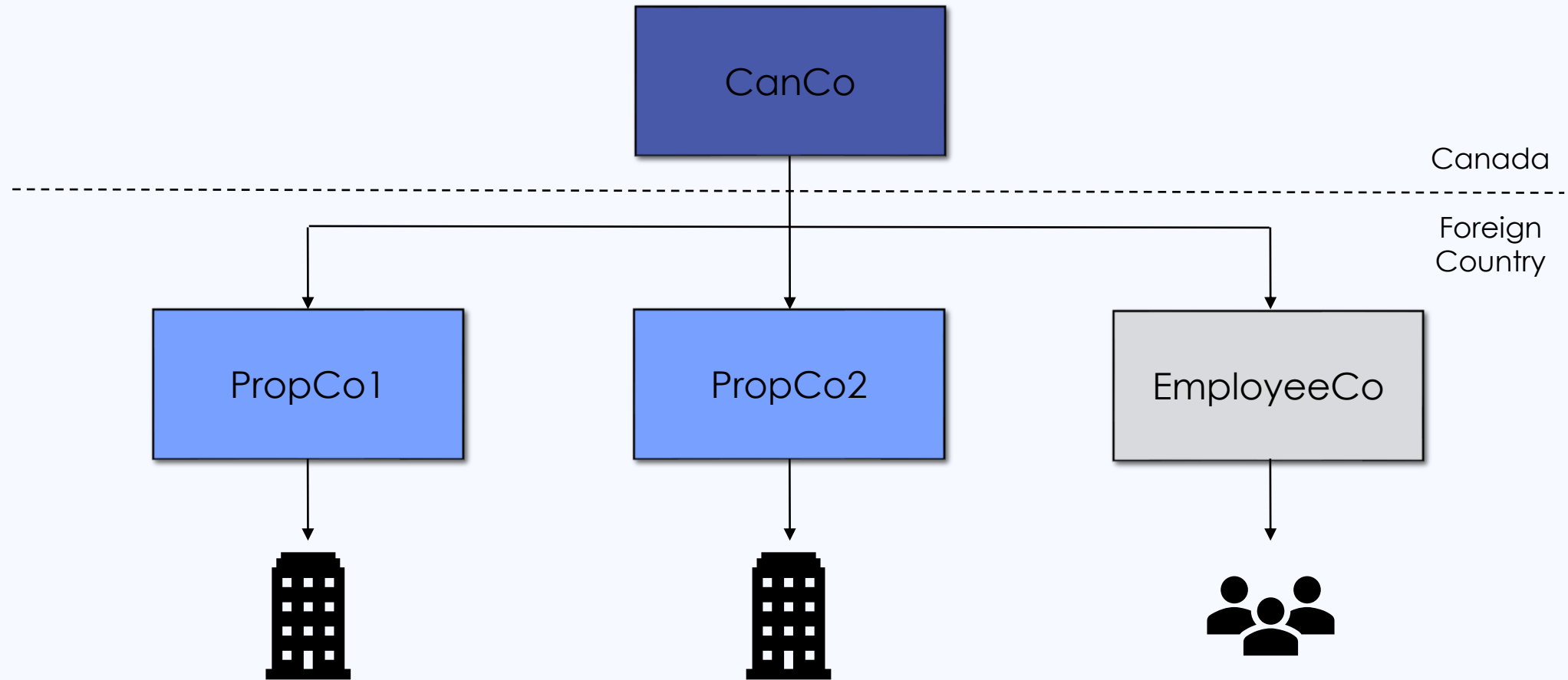




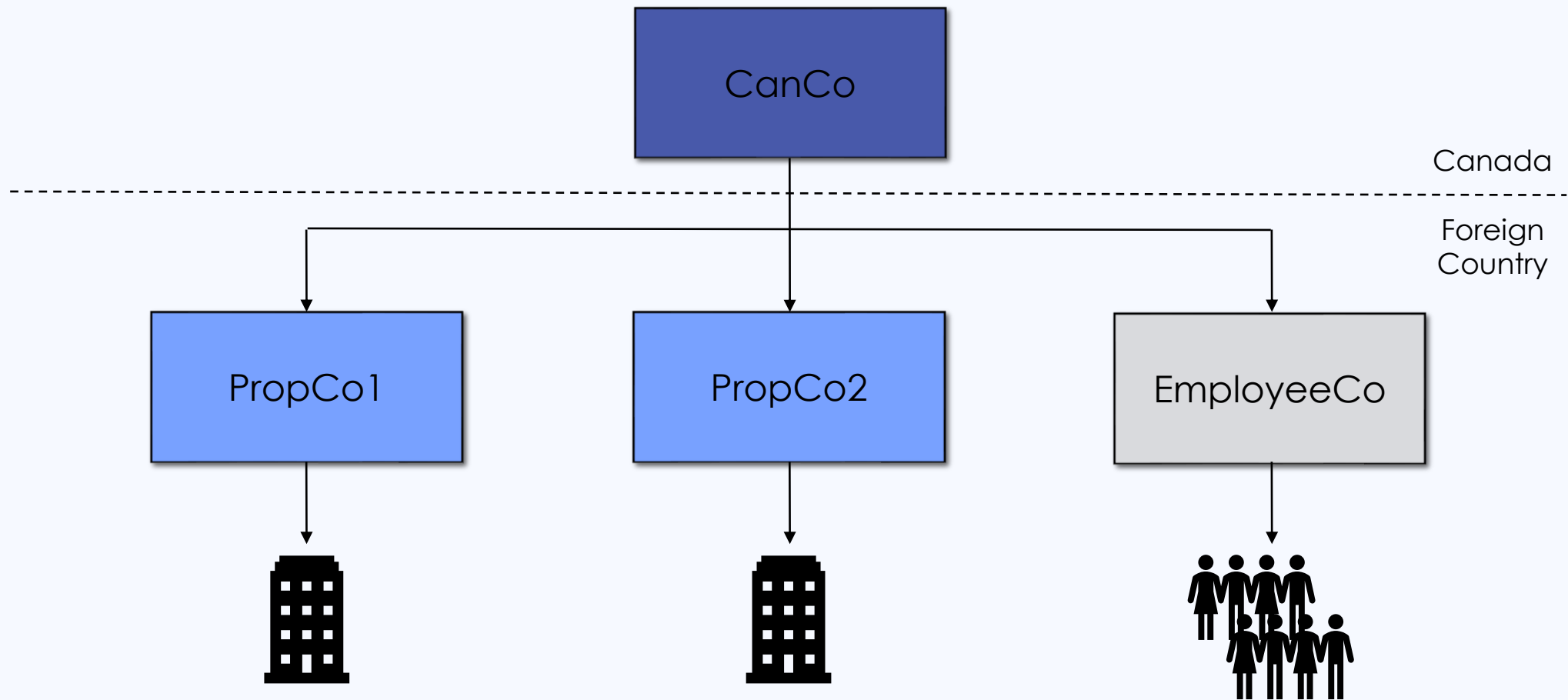
## Definitions

- "Qualifying interest"
- Directly related test
- Hypothetical ABI test

# Mothership – Example 1



# Mothership – Example 2

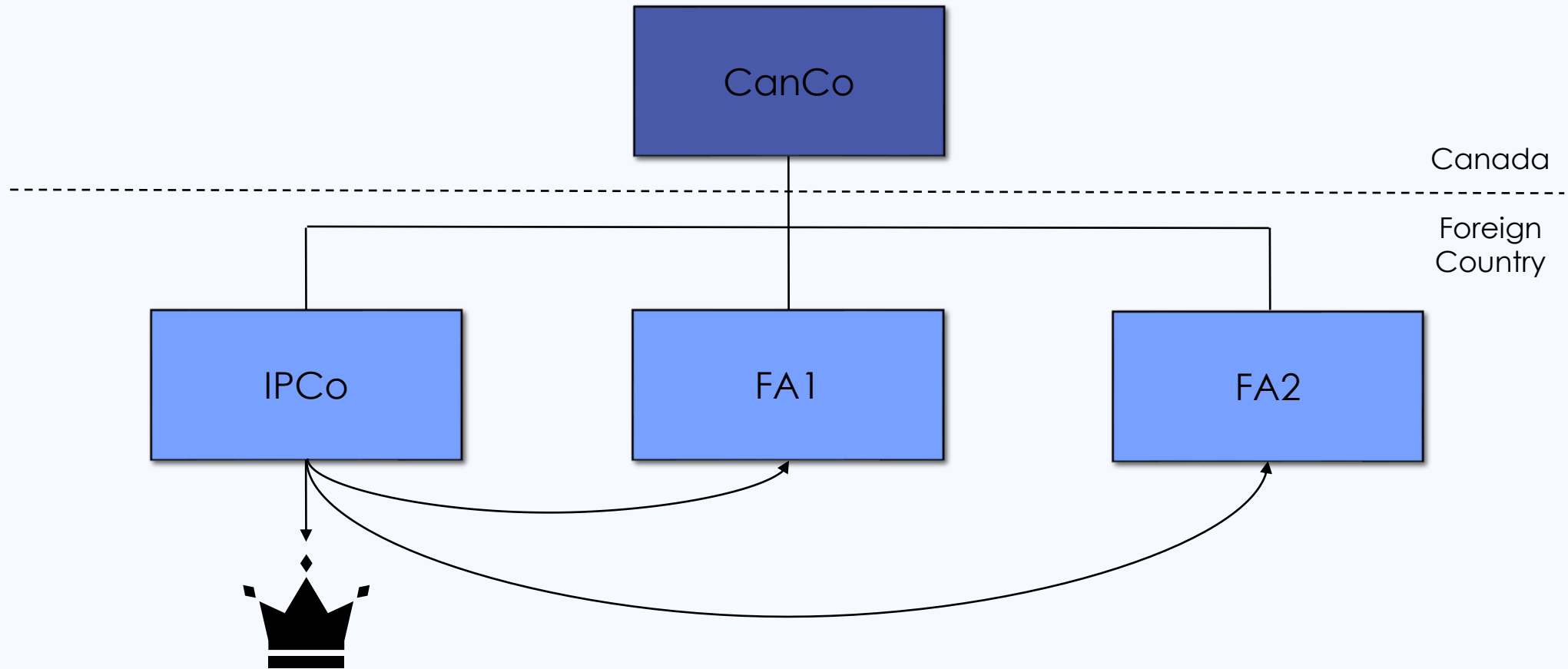


## Cap B – 95(2)(a)(ii)(B)

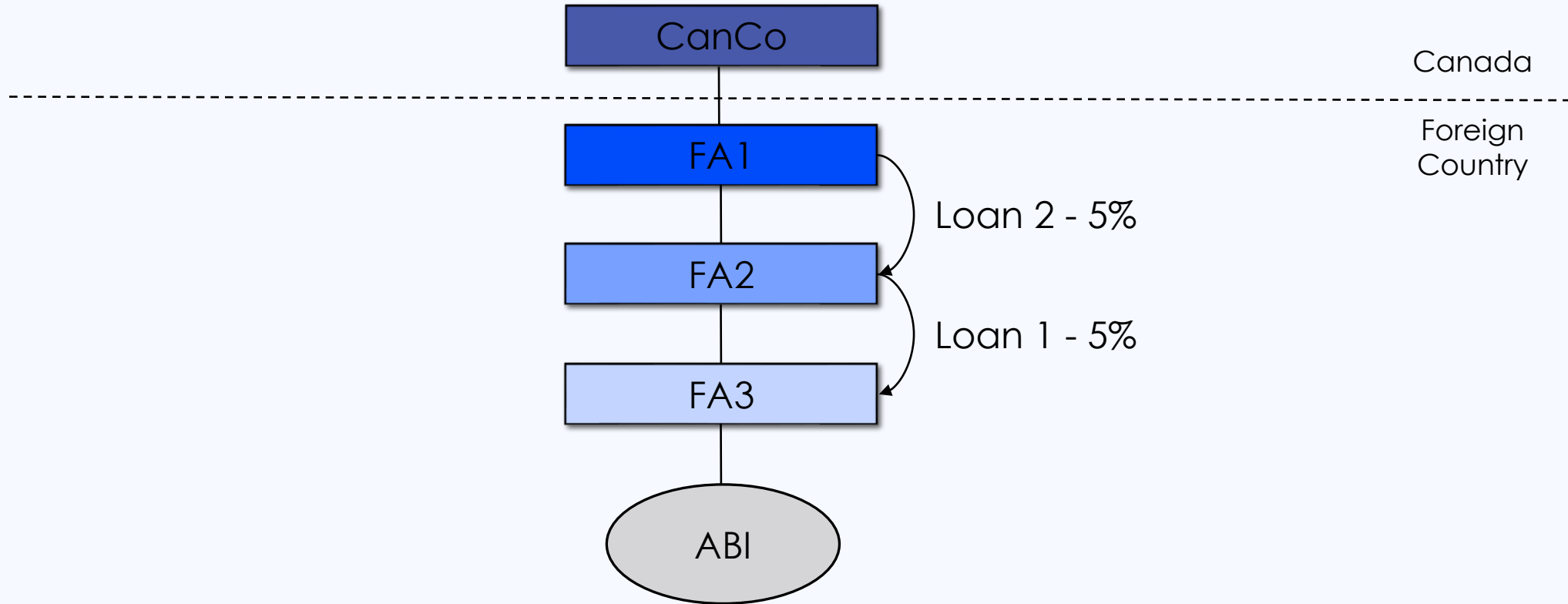
"Qualifying interest" in the "foreign affiliates", and

Amounts are deductible by the "foreign affiliate" debtor in computing its earnings or loss from an active business.

# Cap B – Royalties Example



# Cap B – Interest Example

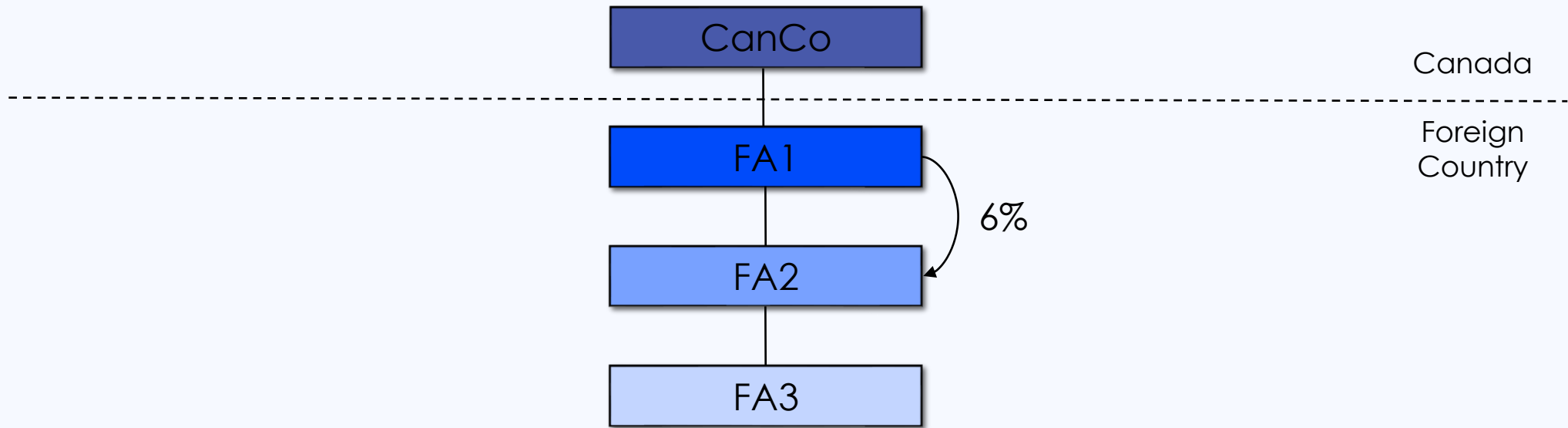


## Cap D – 95(2)(a)(ii)(D)

### Conditions

- Income is derived from amounts paid to a foreign affiliate (the “particular affiliate”) in which the taxpayer has a “qualifying interest”;
- The amounts are paid by another foreign affiliate (“second affiliate”) in which the taxpayer has a “qualifying interest”;
- The amounts are paid by the second affiliate as interest on borrowed money used to acquire shares of another foreign affiliate (the “third affiliate”) in which the taxpayer has a “qualifying interest” that are “excluded property”; and
- The second and third affiliates are each subject to income taxation in a country other than Canada.

# Cap D – Example





3. WHEN IS SERVICES  
INCOME  
RECHARACTERIZED AS  
FAPI?

## 95(2)(b): Income from the Provision of Services

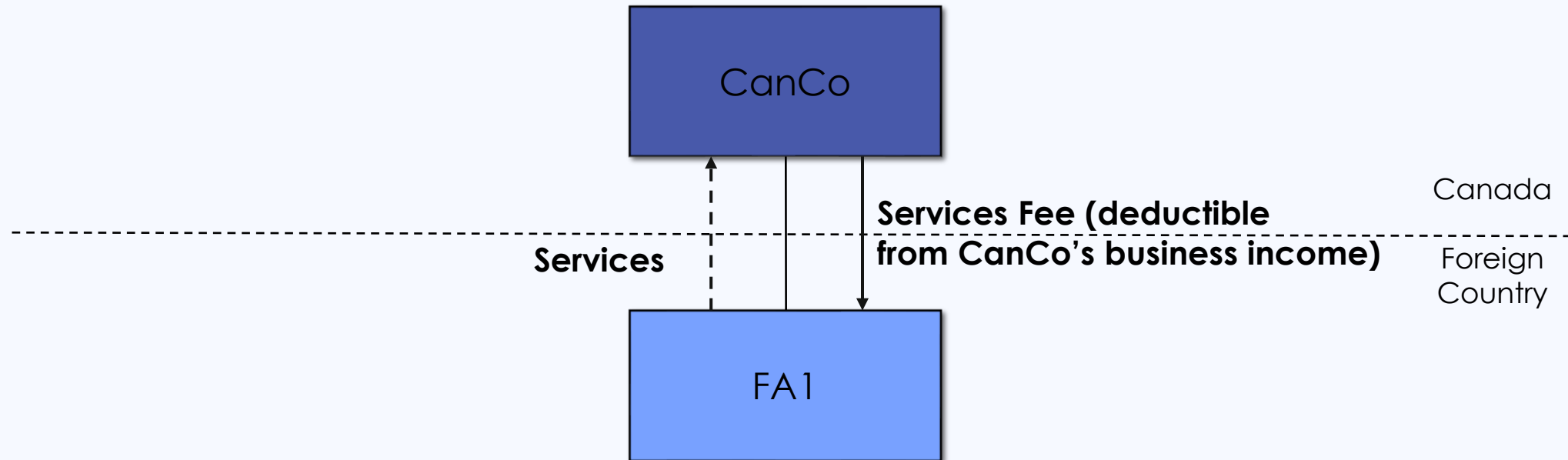
- **Purpose:** Prevents erosion of Canadian tax base through payments to non-resident related parties for the services to Canadian entities.
- **Effect:** Deems provision of services (or undertaking to provide services) by a FA to be a separate business other than an active business and deems the FA's services income to be inactive business income (→ FAPI), when such services reduce Canadian taxpayer's income or FAPI of another FA.
- **Two rules in 95(2)(b):**
  - Subpara (i) depends on deductibility of amounts.
  - Subpara (ii) depends on performance of services.

# 95(2)(b)(i) – Deductibility of Amounts

## Conditions

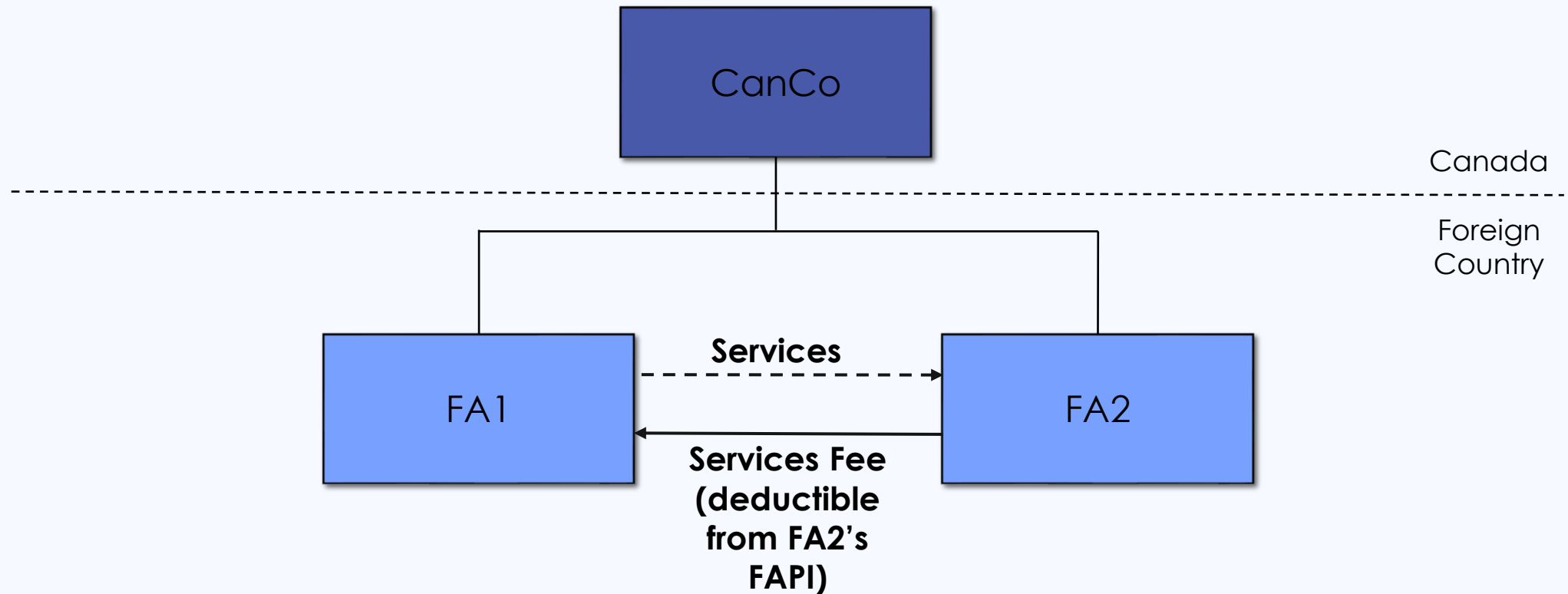
- FA of a Canadian taxpayer provides services (or undertakes to provide services) (“**service provider**”); and
- Amount payable as consideration thereof is deductible in computing:
  - the Canadian business income of the Canadian taxpayer of whom the service provider is a FA (or of another NAL taxpayer) (95(2)(b)(i)(A)); or
  - the FAPI of a FA of (i) any taxpayer of whom the service provider is a FA, or (ii) another taxpayer NAL with (1) the service provider or (2) any taxpayer of whom the service provider is a FA (95(2)(b)(i)(B)).

# Example - 95(2)(b)(i)(A)



**FA1's services income → deemed inactive business income (i.e., FAPI in FA1)**

# Example - 95(2)(b)(i)(B)



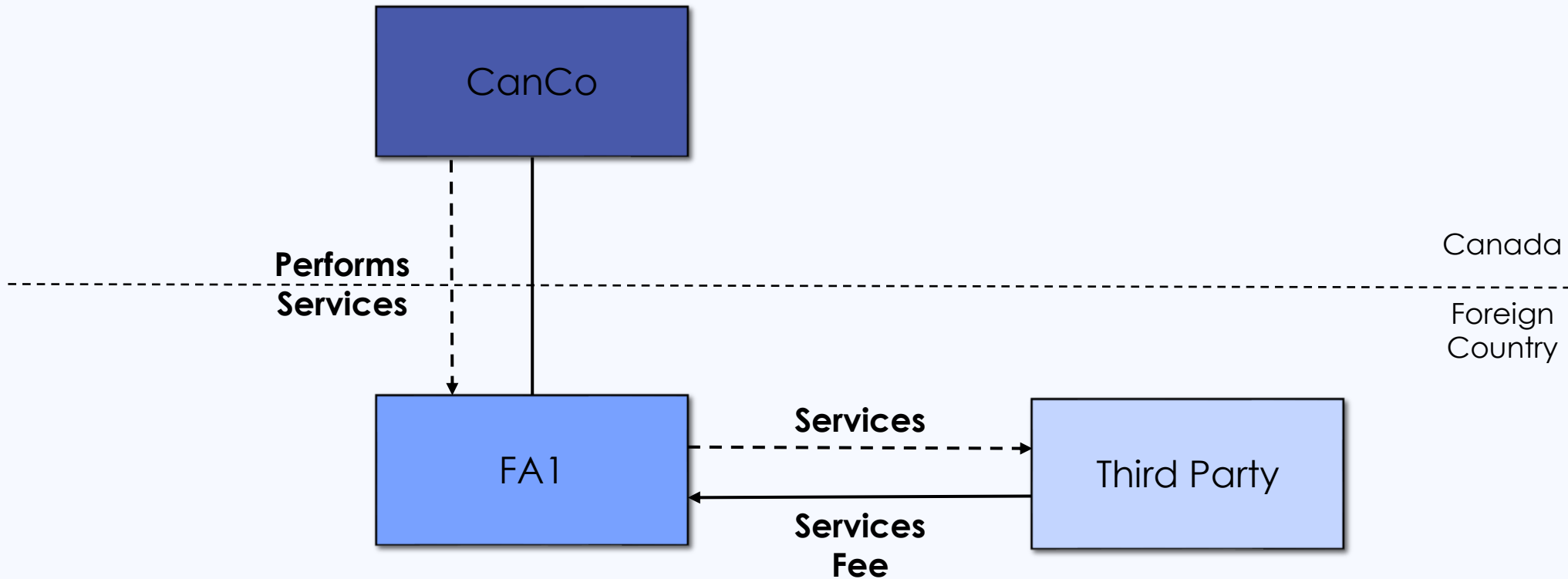
**FA1's services income → deemed inactive business income (i.e., FAPI in FA1)**

## 95(2)(b)(ii) – Performance of Services

### Conditions

- FA of a Canadian taxpayer provides services (or undertakes to provide services); and
- The FA in turn hires (ii) a Canadian taxpayer of whom the affiliate is a FA or (ii) any "relevant person" who is NAL with the FA or any taxpayer of whom the affiliate is a FA, to perform the services.
  - "relevant person" defined in 95(3.02)

# Example of 95(2)(b)(ii)(A)



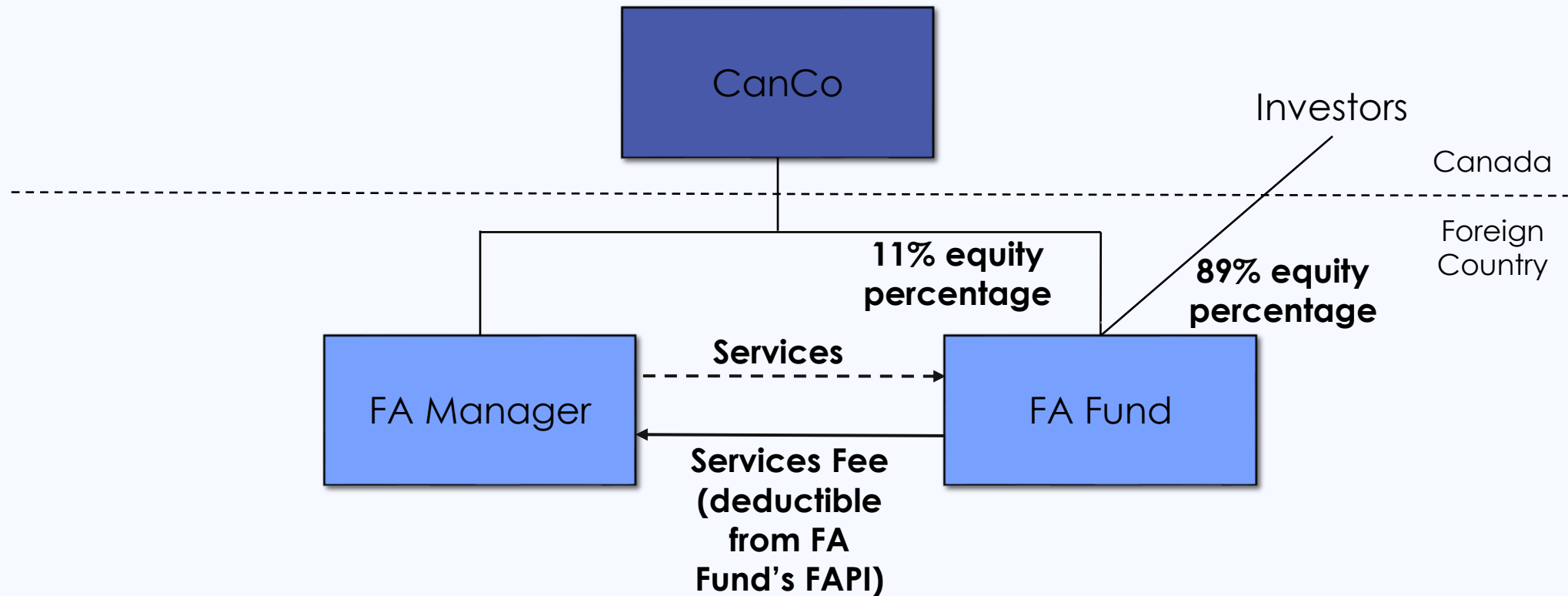
**FA1's services income → deemed inactive business income → FAPI**

## Proposed Amendments re: 95(2)(b)

- Proposed amendments to 95(2)(b)(i) and new 95(3.03).
- Amendments applicable in respect of taxation years of a FA of a taxpayer that end after:
  - 2015 (with respect to 95(2)(b)(i)); and
  - 2016 (with respect to 95(3.03)).



# Current 95(2)(b)(i)(B) Example – 2017 comfort letter

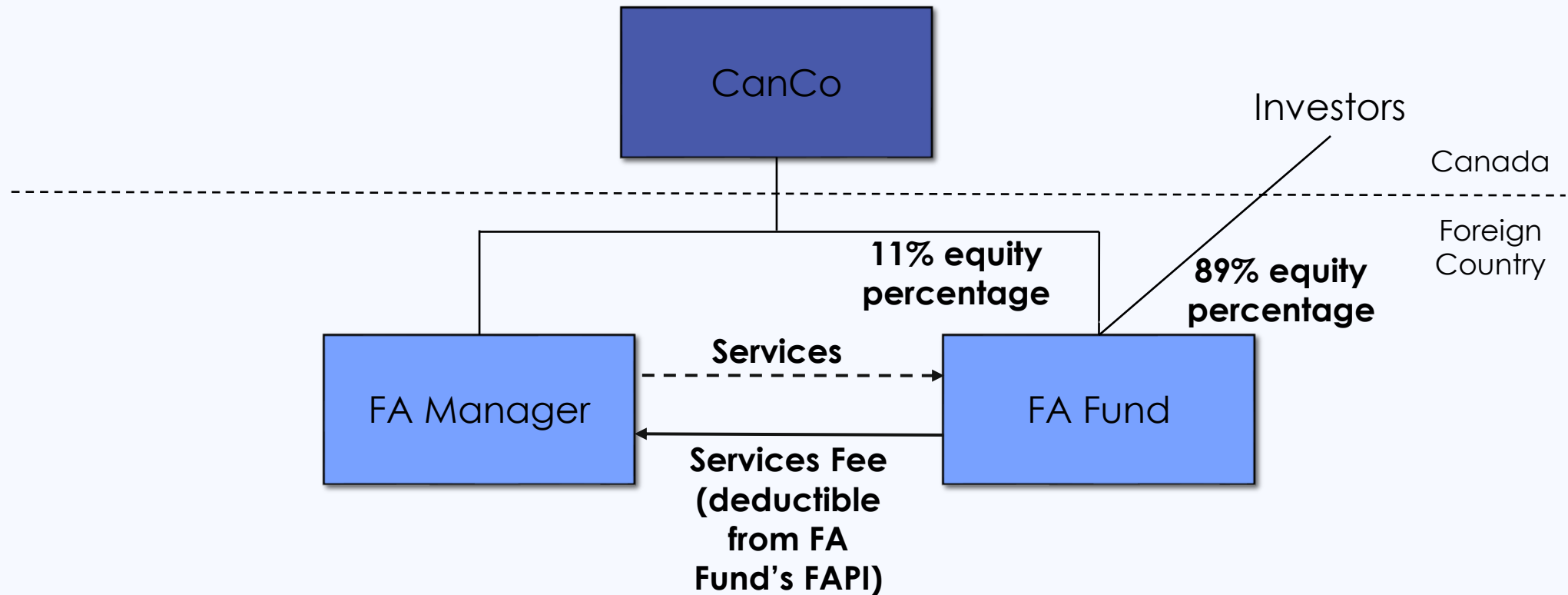


**100% of FA Manager's services income → deemed inactive business income (i.e., because it was deductible in computing FAPI in FA Fund)**

## Proposed Amendment to 95(2)(b)(i)(B)

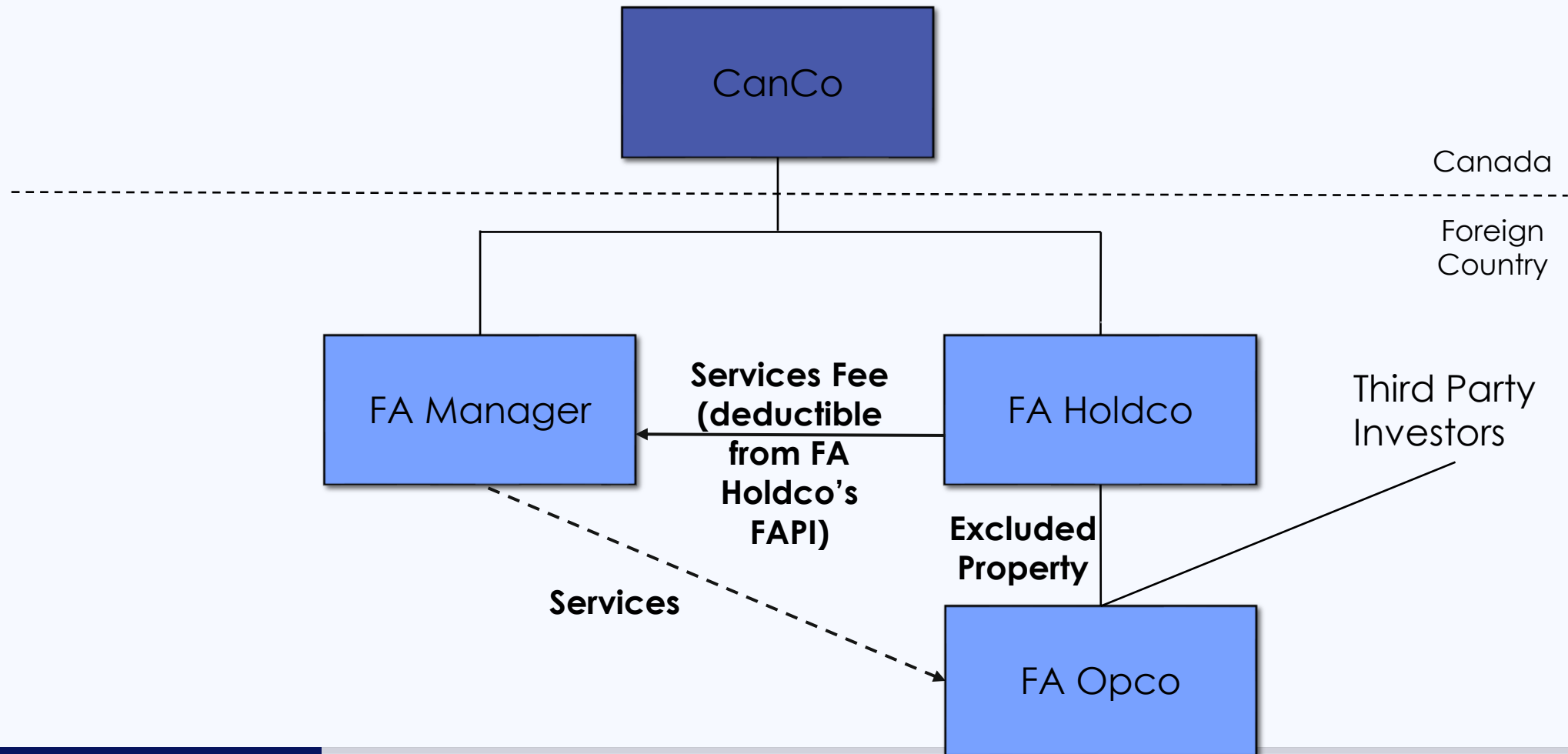
- Proposed amendment limits inclusion of services income in the payee FA's FAPI in proportion to the “participating percentage” of the payer FA held by the taxpayer.

# Proposed Amendment to 95(2)(b)(i)(B)



**Under proposed amendment, 11% of FA Manager's services income → deemed inactive business income (i.e., deductible against Canco's economic interest in the FAPI in FA Fund)**

# 95(2)(b)(i)(B) – 2016 comfort letter



## Proposed 95(3.03) – Exception to 95(2)(b)

### Conditions

- (a) taxpayer has a “qualifying interest” in the payee FA or the payee FA is a controlled FA of the taxpayer;
- (b) taxpayer has a “qualifying interest” in the payer FA;
- (c) the amounts paid or payable by the payer FA for the services are for expenditures incurred by the payer FA for the purpose of gaining or producing income from property;
- (d) the property referred to in (c) is shares of a third FA which are excluded property of the payer FA and taxpayer has “qualifying interest” in the third FA; and
- (e) Payer FA and third FA are subject to tax outside Canada for the relevant year.

## Proposed Subsection 95(3.03)

- Conditions in paragraphs (c) and (d) must be met in respect of all amounts paid or payable by the payer affiliate.
- Where 95(3.03) applies in respect of a provision of services, only the specific provision of services that gave rise to that income for that year is excepted from 95(2)(b)(i).

## Definition of “services” - 95(3)

- For purposes of 95(2) (b), “includes the insurance of Canadian risks”. Not an exhaustive definition.
- **Exceptions:**
  - the transportation of goods;
  - services performed in connection with the purchase and sale of goods;
  - the transmission of electronic signals or electricity along with a transmission system located outside Canada; and
  - the manufacturing or processing outside Canada, in accordance with the taxpayer's specifications and under a contract between the taxpayer and the affiliate, of tangible property that is owned by the taxpayer if the property resulting from the manufacturing or processing is used or held by the taxpayer in the ordinary course of the taxpayer's business carried on in Canada

# The “Goods” Exception

- Only services directly related to the sale of goods qualify for exception:
  - **R&D:** Testing services as part of R&D activities are not directly related to the sale of goods (2013-049736117; 2016-067192117).
  - **Guarantee/warranty:** Services performed in connection with guarantee or warranty associated with product sold are not directly related to the sale of goods (2002-0123755).
- Services provided in connection with sale of **real estate** inventory, including residential condominiums, do not qualify for exception:
  - “Goods” means tangible moveable property (2022-0926191C6).



# The “Manufacturing and Processing” Exception

- Manufacturing or processing outside Canada of tangible property that is owned by the taxpayer if the property resulting from the manufacturing or processing is used or held by the taxpayer in the ordinary course of the taxpayer's business carried on in Canada.
- CRA's general view is that, based on the legislation, R&D services do not qualify as manufacturing or processing activities (2013-049736117; 2016-067192117).